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Supreme Court, U.S.
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No.

In the Supreme Court of the United States

OCTOBER TERM, 1991

UNITED STATES OF AMERICA, PETITIONER

v.

WILLIAM F. HILL AND LOLA E. HILL

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT**

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QUESTION PRESENTED

Whether the unrecovered cost of depreciable improvements to a mineral deposit may properly be included in the adjusted basis of that property in determining the amount of the deduction for depletion that constitutes a tax preference item subject to the minimum tax under Section 57(a)(8) of the Internal Revenue Code, 26 U.S.C. 57(a)(8) (1976).

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WILLIAM F. HILL AND LOLA E. HILL

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The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a) is reported at 945 F.2d 1529.¹ The opinion of the Claims Court (App., *infra*, 2a-23a) is reported at 21 Cl. Ct. 713.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 28a) was entered on September 11, 1991. The court of appeals denied the petition for rehearing on No-

¹ The court of appeals adopted the opinion of the Claims Court (App., *infra*, 2a-23a).

vember 8, 1991 (App., *infra*, 29a) and declined the suggestion for rehearing *en banc* on December 19, 1991 (App., *infra*, 30a). On January 27, 1992, the Chief Justice extended the time for filing the petition for a writ of certiorari to March 7, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 57 of the Internal Revenue Code, 26 U.S.C. 57 (1976),² provides in relevant part:

(a) *In General*.—For purposes of this part, the items of tax preference are—

* * * *

(8) *Depletion*.—With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

* * * *

STATEMENT

1. During 1981 and 1982, respondents were engaged in the business of oil and gas exploration, development and production. This case concerns the

² Subsection 57(a)(8) was redesignated as Subsection 57(a)(1) for taxable years beginning after 1986. This change occurred as part of a revision of Section 57 in the course of enacting the Internal Revenue Code of 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 701(a) and (f)(1), 100 Stat. 2085. Unless otherwise specifically stated, citations in this petition shall be to the Internal Revenue Code as it existed in 1981 and 1982, the years at issue in this case.

proper calculation of the “tax preference” income that they received in those years from the percentage depletion deductions they took under Section 613 of the Internal Revenue Code, 26 U.S.C. 613 (1982).

a. Section 611 of the Code allows taxpayers with an economic interest in oil and gas or other mineral deposits to deduct from their gross income both a reasonable allowance for the depletion of the mineral deposit and a reasonable allowance for depreciation of the tangible improvements to the property (*e.g.*, machinery, pipes and similar items). The allowance for depreciation of “tangible” improvements is based upon the taxpayers’ *costs* of acquiring the improvements; once taxpayers have fully recovered these costs through annual depreciation, no additional deductions are allowed. See 26 U.S.C. 167(c), 1016(a)(2). By contrast, the percentage depletion allowance is based upon the taxpayers’ *revenues* from production of the mineral deposit; this allowance continues so long as revenues are received, even if the costs of acquiring and developing the mineral deposit have been fully recovered. 26 U.S.C. 613.

By permitting deductions that may be far in excess of the actual investment made to obtain and develop the mineral deposit, the percentage depletion allowance provides an unusual tax advantage to mineral producers. See *United States v. Swank*, 451 U.S. 571, 576-577 (1981). In 1969, concerned that high income taxpayers were succeeding in reducing, if not eliminating, their federal income tax liability through extensive use of allowances such as percentage depletion, Congress enacted a minimum tax on “tax preference” income. Congress classified the deduction for percentage depletion as a “tax preference” (26 U.S.C. 57(a)(8) (1976)) and subjected the income

sheltered by the deduction to the minimum tax. During the years involved in this case, the minimum tax was 15% of the amount by which such "tax preference" income exceeded the specific deductions permitted under Section 56 of the Code. See 26 U.S.C. 56 (1976).³

The calculation of the taxpayer's "tax preference" income is the first step in determining this minimum tax. Under Section 57(a)(8), "tax preference" income includes the excess of the percentage depletion deduction in any year "over the adjusted basis of the property" for that year. 26 U.S.C. 57(a)(8) (1976). The statute expressly provides (*ibid.*) that the term "property" in Section 57(a)(8) is to be given the same meaning afforded that term in Section 614 of the Code, 26 U.S.C. 614 (1976). In turn, Section 614 defines the term "property" as the taxpayer's interest in any specific "mineral deposit." *Ibid.*⁴

Under Section 57, percentage depletion deductions are thus treated as "tax preference" items only *after* the taxpayers have fully recovered their cost basis in the "mineral deposit." It is only when deductions are permitted in excess of this cost basis that the ordinary economic principles embedded in the Code

³ Under Section 55 of the current provisions of the Code, items of "tax preference" are now included in the calculation of the "alternative minimum tax." 26 U.S.C. 55. This tax is assessed on tax preference income at the rate of 20% for corporations and 24% for other taxpayers. 26 U.S.C. 55(b)(1) (to be codified).

⁴ 26 U.S.C. 614(a) (1976) provides:

For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(that limit deductions from income to the amount necessary to recover the costs of producing that income) are violated. Percentage depletion deductions taken *before* the taxpayers have fully recovered their investment in the mineral deposit are therefore not treated as tax preference items under the Code. 26 U.S.C. 57(a)(8) (1976).

b. Respondents asserted in the tax returns that they filed for 1981 and 1982 that, in calculating their "tax preference" income, the percentage depletion allowance for each year should be reduced not only by the unrecovered costs of the depletable mineral deposit (*i.e.*, the cost of acquiring ownership of the mineral deposit plus the intangible costs of drilling the well)⁵ but also by the unrecovered cost of the depreciable "tangible" improvements to the mineral deposit (such as pipes, tools and other equipment having salvage value). Since respondents claimed \$206,545 and \$131,216 in unrecovered "tangible" costs in 1981 and 1982 respectively (App., *infra*, 25a), the addition of these costs to the adjusted basis of the depletable mineral deposit substantially reduced respondents' "tax preference" income (App., *infra*, 6a).

The Internal Revenue Service (IRS) concluded that tangible improvements are not part of the "mineral deposit" under Section 57 and that the unrecovered costs of such improvements are therefore not to be considered in calculating respondents' preference in-

⁵ Intangible drilling costs may either be deducted in the year incurred or added to the basis of the depletable mineral deposit. See 26 C.F.R. 1.612-4(a), (b)(1) and (b)(2). As ordinarily occurs, the taxpayers elected in this case to deduct their intangible costs fully when incurred (App., *infra*, 5a). The intangible drilling costs therefore play no role in the "tax preference" calculations in this case.

come (App., *infra*, 6a-7a). The Service thus determined that respondents owed additional taxes under the minimum tax provisions.⁶ Respondents paid the resulting tax deficiencies and filed administrative refund claims. When the IRS failed to grant the requested refunds, respondents filed this suit in the Claims Court.

2. On cross motions for summary judgment, the Claims Court held that respondents were entitled to include the unrecovered costs of depreciable tangible improvements in the adjusted basis of their depletable mineral deposits in calculating the amount of depletion that constitutes an item of tax preference subject to the minimum tax (App., *infra*, 2a-23a). The court acknowledged that "the Code establishes separate rules" for depreciable and depletable property and that "the costs of depreciable improvements to the property are not a factor when calculating the amount of the depletion deduction" (App., *infra*, 9a-10a). The court therefore "admitted[]" (*id.* at 102) that comparing the depletion deduction only to de-

pletable costs (rather than also to depreciable costs) "would create a symmetry of sorts because the unrecovered tangible costs are not a factor when calculating the depletion deduction in the first place" (*ibid.*). While the court recognized (*ibid.*) that "Congress clearly could have decided * * * that unrecovered tangible costs not be a part of the equation" in calculating the tax preference, the court stated that Congress also *could* have chosen to reduce the amount of such tax preference income by deducting unrecovered depreciable costs in order to advance the "aim of encouraging development of oil and gas revenues" (*ibid.*).

Finding no "clear indication" in the text or history of the statute to guide its decision (App., *infra*, 11a & 15a-17a, n.10), the court relied on what it perceived to be the general principle that the word "property"—even as applied to a "mineral deposit"—necessarily encompasses "improvements" to the property (App., *infra*, 11a-23a). The court therefore held that Section 57(a)(8) requires inclusion of unrecovered, depreciable tangible costs in the basis of the "mineral deposit" in calculating tax preference income.

3. The court of appeals affirmed and adopted the opinion of the Claims Court (App., *infra*, 1a). In dissent, Chief Judge Nies observed that the term "property" incorporated by Section 57 from Section 614 refers specifically to the "*mineral deposit*" (App., *infra*, 24a) and that the Claims Court opinion neglected to consider the long-standing distinction between the term "mineral deposit" and the term "mineral enterprise" (App., *infra*, 25a-26a, citing 26 C.F.R. 1.611-1(d)(3)). The term "mineral enterprise" has long been defined by regulations as the

⁶ The parties' computations may be summarized as follows:

| | Respondents | | Government | |
|---|-------------|-----------|------------|------------|
| | 1981 | 1982 | 1981 | 1982 |
| Depletion allowable | \$439,884 | \$371,636 | \$439,884 | \$371,636 |
| Less: Unrecovered intangible costs (expensed) | -0- | -0- | -0- | -0- |
| Less: Unrecovered tangible costs | 206,545 | 131,216 | Disallowed | Disallowed |
| Depletion constituting a tax preference item | \$233,339 | \$240,420 | \$439,884 | \$371,636 |

The tax deficiencies resulting from the government's calculations were \$30,963 for 1981 and \$18,733 for 1982 (App., *infra*, 2a).

"mineral deposit" plus "improvements" (*ibid.*). The distinction that is drawn between "mineral deposit" and "mineral enterprise" is important because "only the mineral deposit itself is subject to a depletion allowance" (App., *infra*, 26a). The Chief Judge noted (*ibid.*, citing 26 C.F.R. 1.611-2(b)(1)):

The capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain * * * specific adjustments. It does not include the cost of improvements * * *.

Under the majority's holding, however, tangible costs that are not part of the basis of the "mineral deposit" (but instead form part of the basis of the "mineral enterprise") "may be transferred over to the mineral deposit so as to reduce the minimum tax" (App., *infra*, 26a). Chief Judge Nies concluded that "a straight forward as well as logical reading of the statute" compels rejection of the claim that Congress intended to include the costs of depreciable improvements in the basis of the taxpayers' depletable "mineral deposit" (App., *infra*, 26a-27a):

Inasmuch as only the deposits themselves are the "property" depletable under Section 611, it is solely the adjusted basis of that "property" which must be deducted from the depletion allowance to arrive at the excess of depletion subject to the minimum tax.

REASONS FOR GRANTING THE PETITION

The decision in this case misapplies the text and history of Section 57 of the Internal Revenue Code to reach an illogical conclusion with dramatic fiscal consequences. The Federal Circuit's decision was issued by a court with nationwide jurisdiction. Since all taxpayers with tax preference income are entitled to pay the tax and sue for a refund in the Federal Circuit, and since such taxpayers tend to be professionally counseled, it is unlikely that other courts of appeals will have an opportunity to review this same issue. In similar circumstances, this Court has recognized the need for plenary review of Federal Circuit decisions that have great fiscal importance. See, e.g., *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 138 (1989); *United States v. American Bar Endowment*, 477 U.S. 105, 109 (1986). Such review is appropriate in this case.

1. The decision of the court of appeals misapplies the definition of "property" incorporated by Section 57(a)(8) from Section 614. The term "property" refers to the taxpayers' interest in a "mineral deposit." 26 U.S.C. 614 (1976). The term "mineral deposit" does not include tangible improvements. To the contrary, the regulations in effect when Congress first enacted Section 57(a)(8) had long distinguished between a "mineral deposit" and a "mineral enterprise," which consists of the "mineral deposit or deposits and improvements" (App., *infra*, 25a-26a, quoting 26 C.F.R. 1-611-1(d)(3)).

By failing to observe the distinction drawn in the statute and the regulations between "mineral enterprise" and "mineral deposit," the court of appeals reached the illogical result that the unrecovered depreciable costs of tangible "improvements" should be

set off against the depletion allowance in calculating tax preference income under Section 57(a)(8). This result is illogical for two reasons. First, it is inappropriate to conclude that costs ultimately to be recovered by *depreciation* may be set off against the depletion allowance for the purpose of determining whether an “excess” recovery of *depletable* costs has occurred (26 U.S.C. 57(a)(8) (1976))—such a conclusion would require the assumption that Congress meant to compare apples (depletion allowance) with oranges (depreciable property) in calculating the amount of the “tax preference.” As Chief Judge Nies stated in dissent, there is “no reason, in logic or in the statute and regulations” why Congress would have designed such a strange and self-defeating scheme (App., *infra*, 26a).

Second, the incongruity of the court’s interpretation of the statute is emphasized by the fact that, under the court’s view, the taxpayer would be allowed to set off the unrecovered balance of depreciable costs *each year*, even when (as here) the depletion allowance in the prior years far exceeds the taxpayer’s basis both in its depletable *and* depreciable property (see note 6, *supra*). The purpose of the minimum tax is to capture and tax, even if at a reduced rate, the special deductions that exceed the taxpayer’s cost basis in assets that receive preferential treatment under the Code. See 26 U.S.C. 57(a)(1)-(10). That purpose is frustrated and impeded by the decision in this case.

Not only does the language of the statute and regulations provide the “clear indication” of the proper construction of these provisions that the courts below found lacking (App., *infra*, 11a), the legislative history provides equally emphatic guidance. Reduced to its essential core, the multi-billion dollar question presented in this case (see pp. 12-13, *infra*) is whether

the word “property” as used in Section 57(a)(8) refers only to the property that is subject to depletion (“depletable property”) or whether it also includes the tangible, depreciable improvements to mineral deposits that are *not* subject to depletion (“depreciable property”) (App., *infra*, 25a-26a). As the court of appeals recognized (App., *infra*, 15a-17a, n.10), the legislative history of the original enactment of Section 57 describes the costs to be included in the basis of the “property” as (i) the costs of acquiring the mineral deposits and (ii) the intangible drilling costs that are also subject to the percentage depletion allowance. See S. Rep. No. 552, 91st Cong., 1st Sess. 114, 115 (1969); note 5, *supra*. This history reflects that the “property” referred to in this statute is the *depletable* property and does not include depreciable improvements that are not subject to percentage depletion.

This evident congressional intent was reemphasized by Congress in 1986 when, in the course of revising and reenacting the Code, Congress revised Section 57 and redesignated subsection 57(a)(8) as 57(a)(1). See note 2, *supra*. The Conference Committee Report on the 1986 Act stated in clear and simple terms how the “tax preference” calculation is to be made for the percentage depletion allowance (H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 254 (1986) (emphasis added)):

The excess over the adjusted basis of the *depletable property* is a preference.

The court of appeals, however, reached the diametrically opposite conclusion that the basis of both depletable *and* depreciable property is to be considered in determining tax preference income. The court’s decision is thus at odds with the clear and direct con-

gressional descriptions of the proper interpretation of the statute.⁷

2. The fiscal consequences of the decision in this case are enormous. The Internal Revenue Service advises that, for the period from 1985 to 1989 alone, more than \$5 billion of revenue from the minimum tax on tax preference income is affected by this decision.⁸ The startling economic effect of this decision was evidently not anticipated by the tax bar (see note 7, *supra*); since the date of the decision, the IRS has received a steady stream of new refund claims (already aggregating in excess of \$400,000,000) that seek to benefit from the surprising Federal Circuit ruling.

The reason this decision has such extraordinary fiscal consequences is that it allows unrecovered depreciable costs to be set off against depletion allowances even after such depletion has fully recovered the costs of investment not only in the "mineral deposit" but in the "mineral enterprise" as well. See page 10, *supra*. The fiscal effect of this decision may be even greater than the Service predicts if the court's analysis is applied not only to the oil and gas and

⁷ Scholarly critiques of the Federal Circuit decision have also expressed strong disagreement with its conclusions. See Dzienkowski & Peroni, *A Critical Review of the Hill Decisions: Calculating Excess Depletion Under The Alternative Minimum Tax*, 28 Nat. Res. Tax Rev. 243 (Sept.-Oct. 1991); M. McMahon, Jr., *Significant Current Developments in Oil and Gas Taxation*, 42nd Annual Institute on Oil & Gas & Taxation, S.W. Legal Foundation § 15.10[2], at 15-53 (1991) ("The court's analysis is alluring, but incorrect.").

⁸ Moreover, since tax returns involving income from mineral deposits are often kept open many years while audits and adjustments are under consideration, the retrospective consequences of the decision could reach back a decade or more.

hard mineral industries under Section 57 but also to the coal and iron ore industries under the parallel language of Section 291(a)(2)(B).⁹ Depreciable improvements represent an even greater portion of the taxpayer's total investment in the "mineral enterprise" for coal and iron ore mining than they do for oil and gas exploration, thus producing an even greater effect in reducing the tax that Congress sought to impose on this preference income.

Thus, while we can safely predict that more than a billion dollars of minimum tax revenues will be lost for each tax year to which this decision applies, it is not possible to place a definite upper limit on the ultimate revenue effect of the court's holding. The revenue losses clearly will be enormous. Moreover, these revenue losses will occur in the precise economic arena that Congress specifically determined was benefiting too greatly from improper preferences under the Internal Revenue Code.

Absent review by this Court, the decision of the court of appeals will significantly frustrate the plain

⁹ Special rules apply to calculation of the depletion allowance for the iron ore and coal mining industries. Section 291 reduces by 20% the depletion allowance available for these industries when the allowance, as computed under Section 613, exceeds the adjusted basis of the "property." 26 U.S.C. 291(a)(2)(B). If the analysis of the word "property" applied by the court of appeals in its decision in this case were applied also to Section 291, a substantial increase in the depletion allowance available to the iron ore and coal mining industries would result. In addition, under the court's interpretation of Section 57(a)(8), the tax preference income attributable to excess depletion allowances for the iron ore and coal mining industries would be substantially reduced, just as it would be for all other mining industries that receive depletion allowances under Section 613.

intent of Congress to limit the economic abuses of tax preference income. Moreover, by entrenching the unfairness that Congress sought to curtail, the decision in this case affects all taxpayers. It enhances the perceived unfairness of the Code that Congress sought to remedy. The inherent result of the decision in this case is to shift the proportion of the total tax burden imposed by the Code away from the few taxpayers who enjoy preference income and onto those who enjoy no preference.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1992

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL AND LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

DECIDED: September 11, 1991

Before NIES, *Chief Judge*, BENNETT, *Senior Circuit Judge*, and LOURIE, *Circuit Judge*.

BENNETT, *Senior Circuit Judge*.

OPINION

The Government appeals the United States Claims Court's judgment granting summary judgment for the taxpayers. 21 Cl. Ct. 713 (1990). The court held that for tax years 1981 and 1982, the taxpayers were entitled to include unrecovered tangible improvements in the computation of the adjusted basis of their oil and gas properties under Internal Revenue Code § 57(a)(8) for the purpose of calculating the amount of depletion which is a tax preference item subject to an alternate minimum tax. We affirm on the basis of the court's opinion which we adopt.

AFFIRMED

(1a)

APPENDIX B

IN THE UNITED STATES CLAIMS COURT

No. 679-88T

(Filed: October 31, 1990)

WILLIAM F. AND LOLA E. HILL, PLAINTIFFS

v.

THE UNITED STATES, DEFENDANT

Tax; claim for refund; deduction; minimum tax; calculation under Section 57(a)(8) of depletion as an item of tax preference; determination of adjusted basis of oil and gas property for calculation of minimum tax; double deductions.

Richard B. Robinson, Denver, Colorado, for plaintiffs. *Robert A. Wherry, Jr.*, of counsel.

Jay G. Philpott, Jr., *Mildred L. Seidman*, and *Gerald B. Leedom*, with whom was *Assistant Attorney General Shirley D. Peterson*, Washington, D.C., for defendant.

OPINION

ANDEWELT, Judge.

In this tax action, plaintiffs, William F. and Lola E. Hill, seek tax refunds for tax years 1981 and 1982 of \$30,963 and \$18,733, respectively. This action is presently before the court on cross-motions for summary judgment. The dispute relates to the amount of taxes plaintiffs were required to pay un-

der the alternative minimum tax provisions set forth in Sections 56 and 57 of the Internal Revenue Code (the Code), 26 U.S.C. §§ 56 and 57.¹ The parties agree that there are no material issues of fact in dispute and that this case turns on a legal issue—the proper interpretation of the pertinent statutes and regulations. For the reasons set forth below, plaintiffs' proposed interpretation is correct and plaintiffs' motion for summary judgment is granted.

I.

During tax years 1981 and 1982, plaintiffs were engaged in the business of oil and gas exploration, development, and production. Pursuant to Section 611 of the Code, when calculating income tax due, an owner of oil and gas deposits is entitled to deduct from his or her income both a reasonable allowance to cover depletion and a reasonable allowance to cover depreciation of improvements.² The Code requires a taxpayer to calculate the depletion deduction in two ways—based on cost depletion pursuant to Section 612 and based on a fixed percentage of the income derived from the property pursuant to Section 613—

¹ For years after December 31, 1982, the alternative minimum tax applicable to individuals is set forth in Sections 55 and 57 of the Code. The references herein to the Code and related Treasury Regulations are to those that applied during the tax years in issue.

² Section 611 provides, in pertinent part:

a) General Rule.—In the case of . . . oil and gas wells . . . there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements . . .; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary.

and then to use the higher amount as the Section 611 depletion deduction. Treas. Reg. 1.611-1(a)(1).

Under Section 57 of the Code, the deduction taken for depletion is classified as an "item of tax preference," which is subject to an alternative minimum tax set forth in Section 56. Section 56 imposes a minimum tax on listed "items of tax preference"³ and Section 57 lists "Depletion" as an item of tax preference. Under Section 57(a), the amount of the depletion deduction that constitutes an item of tax preference is calculated as follows:

(8) Depletion.—With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

The dispute herein relates to the calculation of the amount of the item of tax preference under Section 57(a)(8). The parties agree that when calculating the depletion allowable under Section 611, plaintiffs properly used Section 613 percentage depletion, and that for tax years 1981 and 1982, plaintiffs were entitled to depletion deductions of \$439,884 and \$371,636, respectively. The parties disagree, however, as to how to calculate the "adjusted basis of the property" which, pursuant to Section 57(a)(8), is subtracted from the depletion deduction to determine the amount of the item of tax preference.

³ For tax years 1981 and 1982, Section 56 imposed a 15% tax rate on the excess of the sum of the items of tax preference listed in Section 57 over the deductions allowed in Section 56.

II.

Operators of oil wells incur a variety of drilling and development costs that can be broken down into two categories. The first category is intangible costs and includes "all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). The second category, labeled in the briefs as "tangible costs," involves physical improvements to the property for the operation of the well, *e.g.*, the addition of machinery, tools, equipment, pipes, and similar items "ordinarily considered as having a salvage value." Treas. Reg. 1.612-4(c)(1).

For intangible costs, a taxpayer has the option of either expensing the costs (deducting them totally from his or her income in the year they are incurred) or charging the costs to capital. Treas. Reg. 1.612-4(a).⁴ When the intangible costs are charged to capital, depending on the nature of the costs, a taxpayer recovers the costs either through yearly depletion or depreciation deductions. Intangible costs "represented by physical property" (*i.e.*, the costs of installing physical structures) are returnable through depreciation. Treas. Reg. 1.612-4(b)(2). Intangible costs "not represented by physical property" are returnable

⁴ The general rule in Section 263 of the Code is that a taxpayer cannot expense "[a]ny amount paid out for . . . permanent improvements or betterments made to increase the value of any property." Subparagraph (c), however, carves out a partial exception for "[i]ntangible drilling and development costs in the case of oil and gas wells." The Treasury Secretary is charged with issuing appropriate regulations to implement subparagraph (c), and Treas. Reg. 1.612-4 is the result.

through depletion. Treas. Reg. 1.612-4(b)(1). Examples of intangible costs not represented by physical property are "expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells." *Id.*

For tangible costs, a taxpayer does not have the option to expense the costs, but instead must recover the costs over a period of years. Treas. Reg. 1.612-4(c)(1). In addition, rather than being recovered through a combination of depreciation and depletion deductions, tangible costs are recovered only through depreciation deductions. *Id.*

The parties agree that when calculating the "adjusted basis of the property" under Section 57(a)(8), a taxpayer must add to his or her basis those intangible costs not yet recovered that were properly added to capital and were recoverable through depletion. Since the "adjusted basis of the property" is subtracted from the depletion deduction to determine the amount of the tax preference, the amount of the depletion deduction that would constitute a tax preference item and hence be subject to a minimum tax would decrease as the amount of such unrecovered depletable intangible costs increases. The dispute herein involves the treatment under Section 57(a)(8) of unrecovered *tangible* costs, *i.e.*, tangible costs not yet recovered through *depreciation* deductions. Plaintiffs contend that when calculating the "adjusted basis," the unrecovered *tangible* costs should be treated in the same way as the unrecovered depletable *intangible* costs, *i.e.*, the basis of the property should be adjusted upward to account for the unrecovered costs. Defendant disagrees and contends that unrecovered *tangible* costs do not constitute an adjust-

ment factor when determining the "adjusted basis of the property" under Section 57(a)(8).

III.

Plaintiffs' argument that unrecovered tangible costs are a proper adjustment factor when calculating the "adjusted basis" would give the term "adjusted basis" its ordinary meaning as defined in Sections 1011 through 1016 of the Code. Treas. Reg. 1.57-1(h), which implements Section 57(a)(8), refers taxpayers to Section 1016 for determining the "adjusted basis of the property" for minimum tax purposes. Treas. Reg. 1.57-1(h) provides, in pertinent part: "(3) *Adjusted Basis*. For the determination of the adjusted basis of the property at the end of the taxable year see section 1016 and the regulations thereunder." Section 1016 of the Code, entitled "Adjustments to basis," in turn describes adjustments that should be made to the "basis" of the property.⁵ Section 1016 provides, in pertinent part:

(a) General Rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account.

...

Treas. Reg. 1.1016-2, which implements Section 1016, in turn provides that costs of improvements and betterments to property that are not deductible (*i.e.*, not expensed) are expenditures properly chargeable to

⁵ Section 1011 of the Code, entitled "Adjusted basis for determining gain or loss," in effect defines the term "adjusted basis" as the Section 1012 basis "adjusted as provided in Section 1016." Under Section 1012, the basis of the property is ordinarily "the cost of such property."

the capital account and, hence, should be considered when calculating the "adjusted basis." Treas. Reg. 1.1016-2 provides, in pertinent part:

§ 1.1016-2. Items properly chargeable to capital account.

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property*. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense allowable as a deduction in computing net or taxable income.

(Emphasis added.) Defendant acknowledges that the tangible costs here in issue involve improvements and betterments to plaintiffs' oil and gas properties.*

* Treas. Reg. 1.611-5(b) treats the tangible goods in issue as "improvements" to an oil and gas property. It provides, in pertinent part:

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c).

Hence, relying on this statutory and regulatory scheme, plaintiffs argue that the "adjusted basis of the property" for purposes of Section 57(a)(8) is determined pursuant to Section 1016, and Section 1016 requires an upward adjustment to the basis of the property to account for the costs of unrecovered tangible improvements to the property.

IV.

In response, defendant does not dispute that ordinarily costs associated with tangible improvements to property are added to the basis of the property when calculating the adjusted basis under Section 1016. However, defendant contends that the Code, viewed as an "organic whole" (*see, Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *United States v. Skelly Oil Co.*, 394 U.S. 678, 695 (1969) (Steward, J., dissenting)) demands a different result here. Defendant contends that the Code draws a clear line between depreciation (*see* Section 167) and depletion (*see* Sections 612 and 613) and that adjusting the basis of the property for unrecovered depreciable expenditures when calculating depletion as a tax preference item improperly crosses that line.

Clearly, the Code establishes separate rules for calculating the tax deductions available for depletable and depreciable costs, and the costs of depreciable improvements to the property are not a factor when calculating the amount of the depletion deduction for regular tax purposes under Sections 612 and 613. But the issue herein does not involve the calculation of the amount of the depletion deduction *per se*. Rather, the issue here involves the calculation of the amount of the depletion deduction that constitutes an item of tax preference and hence is subject to a minimum tax.

In drafting the minimum tax provisions, Congress had to make a policy decision as to how much of the depletion deduction should constitute an "item of tax preference" and hence be subject to recapture through the minimum tax. Congress clearly could have decided, as defendant proposes, that unrecovered tangible costs not be a part of the equation and that depletion as a tax preference item be calculated as the excess of the depletion allowance over the cost of the property adjusted exclusively for depletion and unrecovered depletable intangible costs. Admittedly, such an approach would create a symmetry of sorts because the unrecovered tangible costs are not a factor when calculating the depletion deduction in the first place.

On the other hand, it certainly is conceivable that Congress could have decided instead, as plaintiffs propose, that a smaller amount of the depletion deduction potentially be subject to the minimum tax, *i.e.*, that unrecovered tangible costs be included in the adjusted basis and thereby decrease the amount of the tax preference item. The Code provides extensive tax incentives to encourage oil and gas exploration and development. For example, allowing percentage depletion under Section 613 potentially permits a taxpayer depletion deductions that are far in excess of the amount the taxpayer originally paid for the oil and gas deposits. Plaintiffs' proposed interpretation of Section 57 would be consistent with this aim of encouraging development of oil and gas reserves. It would encourage investment in improvements to oil and gas deposits by having the minimum tax not apply to the extent the taxpayer's costs for tangible improvements to the well have not yet been recovered.

The critical focus when resolving which of these policy choices Congress made when it enacted Section 57(a)(8) must be the words of the statute and re-

lated regulations. See *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989); *J.H. Miles & Co. v. United States*, 3 Cl. Ct. 10, 13 (1983). In Code Section 57(a)(8) Congress chose to use a technical tax term—"adjusted basis." Section 1016 describes how to calculate the adjusted basis and, as explained above, does not distinguish between treatment of unrecovered tangible costs recoverable through depreciation and unrecovered intangible costs recoverable through depletion. In effect, Section 1016 requires that the basis of property be adjusted upward to account for all unrecovered costs of improvements properly chargeable to the capital account. When interpreting Section 57(a)(8), absent a clear indication in the Code or related regulations to the contrary, the ordinary Section 1016 meaning of the term "adjusted basis" should apply.

V.

Defendant contends, in effect, that the Code and related regulations contain a clear indication to the contrary. Defendant's argument commences with and relies primarily upon the definition of the term "property" in Section 614 of the Code.

Defendant's argument proceeds as follows. Section 57(a)(8) states that the tax preference applicable to depletion is calculated "[w]ith respect to each property (as defined in section 614). . . ." Section 614, in turn, provides: "For the purpose of computing the depletion allowance . . . of . . . wells, . . . the term 'property' means each separate *interest* owned by the taxpayer in each *mineral deposit* in each separate tract or parcel of land." (Emphasis added.)⁷ Treas.

⁷ Section 614 provides, in pertinent part:

(a) General rule.—For the purpose of computing the depletion allowance in the case of mines, wells, and other

Reg. 1.614-1(a)(2), which implements Section 614, defines the term "interest" to mean "an economic interest in a mineral deposit" and refers to Treas. Reg. 1.611-1 paragraph (b), which in turn defines "economic interest" so as to require the taxpayer to have made a capital investment in the mineral deposit.⁸ Defendant does not dispute that plaintiffs had

natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(b) Special rules as to operating mineral interests in oil and gas wells or geothermal deposits.—In the case of oil and gas wells or geothermal deposits—

(1) In general.—Except as otherwise provided in this subsection—

(A) all of the taxpayer's operating mineral interests in a separate tract or parcel of land shall be combined and treated as one property, and

(B) the taxpayer may not combine an operating mineral interest in one tract or parcel of land with an operating mineral interest in another tract or parcel of land.

(2) Election to treat operating mineral interests as separate properties.—If the taxpayer has more than one operating mineral interest in a single tract or parcel of land, he may elect to treat one or more of such operating mineral interests as separate properties. The taxpayer may not have more than one combination of operating mineral interests in a single tract or parcel of land.

§ 1.611-1 Allowance of deduction for depletion.

* * * * *

(b) *Economic Interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest is possessed in every case in which the taxpayer has . . . in mineral deposition standing timber. An economic interest . . . acquired by investment any interest in mineral in place or standing timber and secures, by any

the required economic interest. Defendant focuses, however, on Treas. Reg. 1.611-1 paragraph (d), which defines the terms (1) "property" to mean each separate interest owned in each "mineral deposit," (2) "mineral deposit" to refer only to the "minerals in place," and (3) "mineral enterprise" to include mineral deposits, improvements, and portions of the surface of the land.⁹ Defendant contends that because

form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. . . . A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation, he possesses a mere economic or pecuniary advantage derived from production.

⁹ Treas. Reg. 1.611-1(d) provides, in pertinent part:

(d) Definitions. As used in this part and the regulations thereunder the term:

(1) "Property" means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614(b), (c), (d), or (e)

* * * * *

(3) "Mineral enterprise" is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) "Mineral deposit" refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

Treas. Reg. 1.611-1(d)(1) defines the term "property" as "minerals in place" and does not refer to improvements. Congress, in referencing the Section 614 definition of property in Section 57(a)(8), must have intended that the taxpayer exclude the cost of such improvements when calculating the "adjusted basis" of the property.

But this conclusion does not follow from the wording of the Code and related regulations. Section 614 defines property "[f]or the purpose of computing the depletion allowance" and further establishes the rules for when a taxpayer can aggregate his or her interests in mineral deposits into a single property. By referencing the Section 614 definition of property, Section 57(a)(8) clearly envisions application of the same rules for tax preference purposes and envisions calculating the item of tax preference based on the same "property" for which the depletion deduction was calculated in the first place.

But, while Section 614 defines "property" in terms of interest in "mineral deposits" and speaks expansively about when interests in mineral deposits can be aggregated into a single property, it says nothing about what adjustments to the cost basis of *that property* are appropriate when calculating the "adjusted basis" of the property. Pursuant to Treas. Reg. 1.57-1(h), that subject is covered in Section 1016 which, as described above, enunciates the rule that "in all cases," adjustment "in respect of the property" shall be made "for expenditures . . . properly chargeable to capital account."

Defendant's proposed interpretation of Section 57(a)(8) blurs the distinction between property and improvements to property. Section 1016 calls for adjusting the basis of the property to account for qualifying unrecovered costs of improvements. There is no

requirement therein that the expenditures and related improvements be the property *per se* in order to have their cost factored in when calculating the "adjusted basis." Stated in another way, it is not material under Section 1016 that the tangible improvements herein are not "mineral deposits" or "minerals in place." An adjustment to the basis under Section 1016 is appropriate so long as the tangible costs involve qualifying improvements to the property, *i.e.*, improvements to the mineral deposits.

Moreover, defendant's contention to the effect that the only item to be considered when calculating the "adjusted basis" is the "minerals in place" is inconsistent with the undisputed way in which the regulations treat intangible costs. As explained above, defendant acknowledges that unrecovered depletable intangible costs "not represented by physical property" are properly added to the basis when calculating the adjusted basis for Section 57(a)(8) purposes. But the subject matter of such unrecovered depletable intangible costs fit no more within the Section 614 definition of "property" than does the subject matter of unrecoverable depreciable tangible costs. More specifically, clearing ground, drilling, shooting, and clearing wells, which involve depletable intangible costs, are no more "mineral deposits" than pumps or pipes, which involve depreciable tangible costs. The definition in Section 614 of "property" is therefore only the starting point in calculating the "adjusted basis of the property." Once the property is defined consistent with Section 614, Treas. Reg. 1.57-1(h) requires that the taxpayer resort to the rules in Section 1016 and related regulations to calculate the "adjusted basis" thereof.¹⁰

¹⁰ At oral argument, defendant characterized the legislative history of Sections 56 and 57 as "not all that helpful." The

VI.

Defendant contends that including tangible costs in the adjusted basis would allow plaintiffs a double deduction of those costs from income and that inter-

court agrees. There are brief statements that arguably benefit each side, but nothing definitive. One statement that arguably aids defendant is a description of depletion as a tax preference item in a Senate Committee Report. S. Rep. No. 91-552, 91st Cong., 1st Sess. 114, 115 (1969-3 Cum. Bull. 423, 497). The Report, issued by the Committee on Finance, comments on a bill (H.R. 13270, 91st Cong., 1st Sess. (1969)) that, after subsequent amendment by a House-Senate Conference Committee, was enacted as Sections 56 and 57. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. In pertinent part, the Senate version established an item of tax preference for oil and gas properties that was calculated by combining two distinct amounts set forth in subparagraphs (A) and (B), respectively. The first amount, set forth in subparagraph (A), was the total amount of intangible drilling and development costs that were expensed by the taxpayer for the tax year. The description of the second amount, set forth in subparagraph (B), involved the depletion deduction and employed the term "adjusted basis." It provided:

(B) the excess of the deduction for depletion allowable under section 611 for the taxable year over the amount which the adjusted basis of the property would have been at the end of the taxable year (determined without regard to the depletion deduction for the taxable year) had the basis of the property been increased by amounts attributable to the property and treated as an item of tax preference under subparagraph (A) for any taxable year.

H.R. 13270, 91st Cong., 1st Sess. 230 (1969). The Senate Report describes this proposed two-part tax preference item, in pertinent part, as follows:

(9) Depletion and intangible drilling and development costs.—This is the sum of two items: the deduction for intangible drilling and development costs . . . and the excess of the depletion deduction taken for the year over the cost of the property reduced for depletion taken in prior years. In this case the intangible drilling and de-

pretations of the Code resulting in double deductions are not favored. See *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62, 68 (1934); *Missouri & Pacific Corp. v. United States*, 5 Cl. Ct. 296, 302 (1984). Clearly, under plaintiffs' approach, the tangible costs would be considered in two different income tax calculations—first, when calculating the adjusted basis of the oil and gas property under Section 57(a)(8) and, second, when the tangible costs are recovered in a later year through a depreciation deduction. But this would not constitute a double deduction from taxable income

velopment costs, to the extent that they are treated directly as a preference item, are treated as a part of the recoverable cost in determining the depletion preference.

S. Rep. No. 91-552, 91st Cong., 1st Sess. 114, 115 (1969-3 Cum. Bull. at 497) (emphasis added). This description of the calculation of the adjusted basis in subparagraph (B) would be generally consistent with defendant's interpretation of Section 57(a)(8) if by "cost of the property" the Senate meant the original cost of the mineral deposits. But it is clear that Congress did not so intend from the very next sentence in the Report, which indicates that expensed intangible drilling and development costs are treated as a part of the cost of the property. In addition, the Conference Report, when describing the item of tax preference relating to the depletion deduction, did not repeat the reference to "cost of the property." Rather, in explaining the calculation involved in Section 57(a)(8), it used the term "cost or other basis on which the depletion preference is computed." H.R. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. 302 (1969-3 Cum. Bull. 644, 659) (emphasis added). Finally, as explained above, it is undisputed that Congress intended the intangible costs that were capitalized and unrecovered to be part of the adjusted basis. In this context, the reference to "cost of the property" in the Senate Report does not demonstrate any unambiguous congressional intent to exclude costs other than the purchase price of the mineral deposits when calculating the "adjusted basis" of the property.

because consideration of these costs when calculating the adjusted basis of the property does not involve a deduction from income.

Sections 56 and 57 establish a separate (alternative) tax scheme, which, through a minimum tax, effectively recaptures certain deductions allowed under the Code. Each item of tax preference in Section 57 relates to a specific deduction allowable in a separate section of the Code. This minimum tax scheme involves four steps: (1) individual items of tax preference are calculated (*i.e.*, the part of the deduction potentially subject to the minimum tax is calculated); (2) the amounts of the individual items are then added together; (3) specified deductions are allowed from that total;¹¹ and (4) the minimum tax rate is then applied to the remainder. (Section 56.) Thus, the first step—the calculation of the individual tax preference items—is directed at defining one part of a pool of certain tax deductions allowed under the Code, which after *subsequent* deductions is subject to the minimum tax.

With respect to Section 57(a)(8), the first step can be viewed as a determination of how much of the depletion deduction is potentially subject to the minimum tax or, in the alternative, as a determination of how much of the income originally sheltered from taxation through a depletion deduction will be subject to

¹¹ Code Section 56(a) allows a taxpayer to deduct from the sum of the items of tax preference the greater of \$10,000 or "the regular tax deduction." Section 56(c) defines "the regular tax deduction" as "an amount equal to one-half of . . . the taxes imposed by this Chapter for the taxable year," after specified adjustments (*e.g.*, taxes under certain sections are excluded and the sum is reduced by certain tax credits). Section 56(b) allows a deferral of the minimum tax calculated in certain instances where the taxpayer has a new operating loss.

a tax. See *Mobley v. United States*, 8 Cl. Ct. 767 (1985). But under neither interpretation would the first step's calculation of the adjusted basis and the item of tax preference amount to taking a deduction from otherwise taxable income.

Indeed, defendant's double deduction theory, which treats the inclusion of tangible costs in the Section 57(a)(8) adjusted basis as involving a deduction of those costs from income, is inconsistent with the way defendant acknowledges the Code and regulations operate for other costs. There is no dispute that under the controlling statutes and regulations other costs are included in the adjusted basis (*e.g.*, the unrecovered purchase price of the minerals and the unrecovered depletable intangible costs of improvements). But, these other costs, like the tangible costs, are recoverable through deductions in later years. Therefore, consistency with defendant's double deduction theory would require that these other costs also be excluded from the adjusted basis.¹²

¹² In its briefs, defendant seeks to support its double deduction theory by citing the following statement in the Senate Committee Report (*see n. 10, supra*).

As a general rule, the deductions provided under the regular individual and corporate income taxes will not be allowed for purposes of the minimum tax. This is because once the items have been deducted under the regular income tax, allowing them over again under the minimum tax would provide duplicate tax allowances. The committee's provision makes one exception to this rule with regard to net operating losses.

S. Rep. No. 91-552, 91st Cong., 1st Sess. 116, 117 (1969-3 Cum. Bull. at 423, 498).

But in view of the discussion above, this statement cuts against defendant. As noted, there is no dispute that the unrecovered purchase price of the mineral deposits and the unrecovered intangible depletable costs are included in the adjusted basis under Section 57(a)(8) and therefore are simi-

There is one situation where the Treasury regulations clearly do provide that the cost of depreciable improvements are to be excluded when calculating the "basis" of oil and gas properties. That situation is when a taxpayer calculates his or her depletion deduction by using the Section 612 cost depletion rather than the Section 613 percentage depletion. Treas. Reg. 1.612-1 specifically states, however, that the required procedure involves a "special rule"—an exception to the ordinary procedures used for calculating the adjusted basis. It provides, in pertinent part:

§ 1.612-1 Basis for allowance of cost depletion.

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section

larly subtracted from the depletion deduction in the first step calculation of the minimum tax scheme. If the subtraction of these costs from the amount of the deduction in the first step calculation were viewed as a deduction from income, the Senate would also have listed these costs in addition to the net operating loss as "exceptions" to the "no double deduction" comment.

In any event, this is not a situation where plaintiffs are "allow[ed] . . . over again" a deduction already "deducted under the regular income tax." As noted above, the calculation of the amount of an item of tax preference does not involve any deduction from income. In addition, the tangible costs plaintiffs seek to add to the adjusted basis have never previously been deducted from income—they are being added to the basis precisely because they are unrecovered. When placed in context, it seems clear that in the quoted statement, the Senate was referring to deductions taken during the third step of the minimum tax scheme in which deductions are taken from the sum of the items of tax preference. The Senate was not referring to the first step in which items of tax preference are calculated by subtracting certain amounts from the deductions allowed under the regular income tax.

1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. . . .

(b) *Special rules.* (1) The basis for cost depletion of mineral, or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion

Section 612 and Treas. Reg. 1.612-1 do not help defendant. First, Section 612 is not involved because plaintiffs calculated their depletion allowance using percentage depletion under Section 613, rather than cost depletion under Section 612. Second, as summarized above, while it is clearly appropriate to exclude depreciable costs when calculating the amount of the depletion deduction in the first place, the minimum tax presents a distinct policy issue that reasonably could have been resolved by Congress in a different way. Third, and most significantly, the controlling statutes and regulations contain no equivalent "special rule" for assessing the "adjusted basis" of the property under Section 57(a)(8). To the contrary, Treas. Reg. 1.57-1(h)(3) appears to mandate use of the ordinary Section 1016 procedures by stating: "For the determination of the adjusted basis of the property at the end of the year see section 1016 and the regulations thereunder."

Indeed, rather than aiding defendant's proposed interpretation of Section 57(a)(8), Section 612 would appear to favor plaintiffs' interpretation. By specifying that for Section 612 cost depletion purposes a "special rule" applies under which amounts recover-

able through depreciation are excluded from the "basis" of the property, Treas. Reg. 1.612-1 would appear to acknowledge that absent such a "special rule," the basis of Section 614 property would include such amounts.

VIII.

"Technical Advice Memoranda" (TAM) issued by the Internal Revenue Service (IRS) are not binding on the IRS. However, the approach the IRS took in TAM 8314011, issued on December 22, 1982, is instructive. That memorandum involved a calculation of the depletion item of tax preference under Section 614 property. The taxpayer amended its return to include in the "adjusted basis" of the property certain intangible costs that had been capitalized rather than expensed and had not yet been recovered. The IRS approved this adjustment stating: "The term 'adjusted basis' has the same meaning whether used in section 57(a)(8), section 612, or elsewhere in the Code except where the term is specifically defined differently."

A taxpayer is entitled to such consistency in definition. Where Congress and the Department of Treasury choose to employ a technical term such as "adjusted basis," a taxpayer must be given reasonable notice when the term is intended to have other than its ordinary meaning in the Code. Herein, no such notice was supplied, and plaintiffs calculated their taxes according to the ordinary meaning of the terms in the controlling statutes and the regulations. Taxpayers can be expected to do no more. Taxpayers are obliged to do no more.

Conclusion

For the reasons set forth above, plaintiffs' motion for summary judgment is granted and defendant's cross-motion is denied. The Clerk of the Court shall enter judgment for plaintiffs in the amounts of \$30,963 for tax year 1981, and \$18,733 for tax year 1982, plus statutory interest thereon.

IT IS SO ORDERED.

/s/ Roger B. Andewelt
ROGER B. ANDEWELT
Judge

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

NIES, *Chief Judge*, dissenting.

Congress has imposed a minimum tax on "items of tax preference" to insure that taxpayers with substantial economic income could not avoid significant tax liability by using exclusions, deductions, and credits. In general, for taxable years 1981 and 1982, the years at issue here, a minimum tax of 15 percent rate was imposed on a portion of the taxpayers' "items of tax preference." See 26 U.S.C. § 56(a) (1982).*

The particular "item of tax preference" at issue here concerns a deduction for depletion of a mineral deposit allowable under section 611. Under section 57(a)(8) of the Code, the portion of a depletion deduction that constitutes an "item of tax preference" is the excess of such deduction over the "adjusted

* All references are to the Internal Revenue Code, codified at Title 26 of the United States Code, applicable during 1981 and 1982, the tax years in issue.

basis of the property." The amount of depletion allowed for taxpayers' oil and gas deposits for taxable years 1981 and 1982 under section 611 is \$439,884 and \$371,636, respectively. The point of disagreement is over whether those amounts should be reduced by the unrecovered depreciated costs of certain machinery, pipes and equipment as a part of the "adjusted basis of the property." The amount of the depletion deduction subject to the alternative minimum tax as a tax preference item is then reduced to \$233,339 and \$240,420 in 1981 and 1982, respectively.

Cost is the starting point for determining the "basis" of property. See 26 U.S.C. § 1012. Section 1016 then sets out what adjustments can be made to the cost and provides that "[p]roper adjustment in respect of the property shall in all cases be made— (1) for expenditures * * * properly chargeable to capital account." I disagree with the majority that this provision permits the costs of machinery and the like to be added as an "adjustment" to the "basis" of a mineral deposit so as to reduce the amount of a tax preference item for minimum tax purposes. The reason for my conclusion is the reference in section 57(a)(8) to section 614 for the definition of "property." Section 614(a) states that "the term property means each separate interest owned by the taxpayer in each mineral deposit" (Emphasis added.) Giving that definition to the term "property" where it appears in sections 57(a)(8) and 1016 means one must determine the adjusted basis of the mineral deposit.

A mineral deposit has a special meaning. As explained in the regulations, a mineral deposit may be part of a mineral enterprise. A mineral enterprise is defined in section 1.611-1(d)(3) as "the mineral de-

posit or deposits and improvements, if any, used in mining or in the production of oil and gas and only so much of the surface land as is necessary for purposes of mineral extraction." The distinction between a mineral deposit and a mineral enterprise must be made because only the mineral deposit itself is subject to a depletion allowance under section 611. In order to obtain that tax benefit, the taxpayer must maintain a separate capital account for the mineral deposit. See *Treas. Reg. § 1.611-2(b)(1)* (1982). The capital account of the mineral deposit on which depletion is calculated includes the cost of the deposit itself and certain exploration costs and other specific adjustments. It does not include the cost of improvements used in production, such as machinery and pipes. The latter are adjustments only to the enterprise. There is no disagreement here over what items enter into calculation of the basis of the property for purposes of the depletion allowance. However, when it comes to determining how much of the basis of the property has not been depleted, the majority allows an additional item to be added. Costs which are part of the capital account of the enterprise, per the majority, may be transferred over to the mineral deposit so as to reduce the minimum tax.

I see no reason, in logic or in the statute and regulations, why costs of capital improvements, which have nothing to do with the calculation of depletion under section 611 of the Code, should be added to the adjusted basis of the oil and gas deposits for purposes of reducing the alternative minimum tax. I agree with the government's analysis that inasmuch as only the deposits themselves are the "property" depletable under section 611, it is solely the adjusted basis of that "property" which must be deducted from the de-

pletion allowance to arrive at the excess of depletion subject to the minimum tax. Section 57(a)(8) clearly envisions application of the same rules for tax preference purposes and calculation of tax preference items based on the same "property" for which the depletion deduction was calculated in the first place. The Claims Court found it conceivable that Congress could have decided that it would decrease the amount of the tax preference item by the amount of unrecovered depreciable property costs so as to encourage investments and improvements to oil and gas deposits by having the minimum tax not apply to the extent the taxpayers' costs for tangible improvements to the well have not yet been recovered. The trial judge concluded the statutory provisions result in that policy choice. I disagree. It appears to me that a straight forward as well as logical reading of the statute indicates its rejection.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

JUDGMENT

ON APPEAL from the UNITED STATES
CLAIMS COURT in CASE NO. 679-88TThis CAUSE having been heard and considered,
it is

ORDERED and ADJUDGED:

AFFIRMED.

ENTERED BY ORDER OF THE COURT

/s/ Francis X. Gindhart
FRANCIS X. GINDHART
Clerk

Dated Sep. 11, 1991

Issued as a Mandate: November 15, 1991

APPENDIX E

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

91-5032

WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES

v.

THE UNITED STATES, DEFENDANT-APPELLANT

ORDER

Before NIES, Chief Judge, BENNETT, Senior Cir-
cuit Judge, and LOURIE, Circuit Judge.A petition for rehearing having been filed in this
case,

UPON CONSIDERATION THEREOF, it is

ORDERED that the petition for rehearing be, and
the same hereby is, denied.

Chief Judge Nies would rehear the appeal.

The suggestion for rehearing in banc is under con-
sideration.

The mandate will issue on November 15, 1991.

FOR THE COURT,
FRANCIS X. GINDHART

Clerk

Dated: November 8, 1991

cc: GARY R. ALLEN
RICHARD B. ROBINSON

APPENDIX F**UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT**

91-5032**WILLIAM F. HILL and LOLA E. HILL,
PLAINTIFFS-APPELLEES***v.***THE UNITED STATES, DEFENDANT-APPELLANT**

ORDER

A suggestion for rehearing in banc having been filed in this case, and a response thereto having been invited by the court and filed,

UPON CONSIDERATION THEREOF, it is

ORDERED that the suggestion for rehearing in banc be, and the same hereby is, declined.

FOR THE COURT,
FRANCIS X. GINDHART

Clerk

Dated: December 19, 1991

cc: GARY R. ALLEN
RICHARD B. ROBINSON

APPENDIX G**IN THE UNITED STATES CLAIMS COURT**

No. 679-88 T**WILLIAM F. and LOLA E. HILL***v.***THE UNITED STATES**

JUDGMENT

Pursuant to the opinion of October 31, 1990, directing entry of judgment for plaintiffs,

IT IS ORDERED AND ADJUDGED this date, pursuant to Rule 58, that plaintiffs recover of and from the United States the sums of \$30,963 for tax year 1981, and \$18,733 for tax year 1982, plus statutory interest thereon, with costs to the prevailing party.

FRANK T. PEARTREE
Clerk of Court

October 31, 1990

By: /s/ Linda A. Eddins
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see
RUSCC 72. Filing fee is \$105.00